ESG INVESTING AND PROXY VOTING: DOL'S NEW FINAL RULE

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U.S. Asset Management and Investment Funds and ERISA Fiduciary Alert

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Executive Summary: The Department of Labor released a final rule that addresses fiduciary duties when (1) considering ESG factors in selecting investments, and (2) considering whether and how to vote proxies, for plans subject to ERISA. The rule is intended to remove what DOL perceived as a chilling effect of a Trump-era rule on considering ESG factors in connection with plan investments, as well as to reiterate core principles for fiduciary decision-making with respect to investing and proxy voting. The new rule has important implications for investment advisers and consultants to assets subject to ERISA, such as corporate defined benefit pension plans, corporate 401(k) plans, and "plan asset" funds. In addition to the new Department of Labor rule, advisers should be mindful of final and proposed Securities and Exchange Commission rules, U.S. state-level laws and regulations, non-U.S. laws and regulations, and the political environment when developing and managing investment products that integrate or focus on ESG investment themes. We are available to assist with reconciling the many relevant considerations.

The Department of Labor (DOL) recently released its final rule on "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (Rule). The Rule overwrites a rule adopted during the Trump administration that DOL viewed as having a chilling effect on fiduciaries considering environmental, social, or governance (ESG) factors in connection with investments for investors subject to the Employee Retirement Income Security Act of 1974 (ERISA), such as corporate defined benefit plans, 401(k) plans, and "plan asset" funds. The Rule also addresses fiduciary duties when voting, or determining when to vote, proxies.

The effective date of the Rule is 30 January 2023, 60 days after the date of publication in the Federal Register. (Certain provisions regarding proxy voting and the exercise of shareholder rights will have a delayed applicability date until 1 December 2023.)

In the Rule, DOL emphasizes that the core principles for fiduciary decision-making with respect to investing and proxy voting have not changed. The core principles are (1) ERISA's duties of prudence and loyalty require fiduciaries to focus on relevant risk-return factors and not subordinate the interests of plan participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan, and (2) ERISA's fiduciary duty to manage plan assets that are shares of stock includes the management of shareholder rights appurtenant to those shares, such as the right to vote proxies.

Some key takeaways and practical implications from the Rule:

ESG Factors Should be Evaluated Like any Other Potential Investment Factor

ESG factors may, or may not, be relevant in the risk-return analysis of an investment. In the Rule, DOL sought to avoid the perception that DOL favored ESG factors by removing language from the proposal that investment analysis “may often require” consideration of ESG factors, while also addressing the perceived chilling effect of the Trump-era rule. To do so, DOL used a principles-based approach. The Rule sets out the following three principles:

1. A fiduciary's determination with respect to an investment or investment course of action must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis;
2. Risk and return factors may include the economic effects of climate change and other ESG factors on the particular investment or investment course of action. Whether any particular consideration is a risk-return factor depends on the individual facts and circumstances; and
3. The weight given to any factor by a fiduciary should appropriately reflect an assessment of its impact on risk and return.

As a practical matter, ERISA fiduciaries should evaluate specific ESG factors in accordance with the principles articulated above and prudent investor standards.

The Tie-Breaker Standard is now More Flexible

The Rule modifies the previous rule to allow a more flexible approach. Under the previous rule, competing investments were required to be “economically indistinguishable” before fiduciaries could turn to collateral factors as tie-breakers. Some believed that strict standard, which also imposed a special documentation requirement when considering collateral factors to make an investment decision—rendered the tie-breaker approach impossible to use. Under the Rule, if a fiduciary prudently concludes that competing investment opportunities “equally serve the financial interest of the plan,” the fiduciary is not prohibited from selecting an investment based on “collateral benefits other than investment returns.” In addition, the special documentation requirement was removed. ERISA's general prudence standards with respect to documentation continues to apply.

As a practical matter, the new tie-breaker standard should be easier to use, because fiduciaries will not need to show that competing investments are economically indistinguishable. In addition, the removal of the special documentation requirement may increase the use of the tie-breaker standard, as the documentation requirement may have had a chilling effect on the use of otherwise prudent investments, out of fear that a dissatisfied participant or other party could claim deficient documentation in litigation. A plan fiduciary should still consider documenting the use of the tie-breaker standard and collateral factors in decision-making in accordance with ERISA's general fiduciary duties of prudence.

If an ESG factor is reasonably determined to be relevant to the risk-return analysis of an investment, it should not be considered a “collateral” factor subject to the tie-breaker standard. Instead, as discussed above, it should be considered in the risk-return analysis along with other relevant “traditional” risk-return factors.

Plan Participants' Preferences

Under the Rule, a fiduciary does not violate its duty of loyalty solely because the fiduciary takes into account participants' preferences when constructing a menu of prudent investment options. Taking plan participants' preferences into account can encourage greater participation in the plan and higher deferral rates, and thus lead to greater retirement security. As discussed in the preamble to the Rule, giving consideration in this way to whether an investment option matches participants' preferences “can be relevant to furthering the purposes of the plan.”

The new guidance in the Rule does not alter the fiduciary duty of prudence, however; it only speaks to the plan fiduciary's duty of loyalty. A plan fiduciary still “may not add imprudent investment options to menus just because participants request or would prefer them.”

As a practical matter, while the guidance in the Rule may provide some comfort that a plan fiduciary does not violate its duty of loyalty when taking into account participants' preferences for ESG-focused investment options, such options must still be prudent in order to comply with ERISA's fiduciary duties. While this new guidance is given in the context of ESG factors, fiduciaries may want to consider whether the same logic would apply to other types of investment options, such as private equity or proprietary funds.

Special Rules for QDIAs Were Removed

Many retirement plans automatically enroll employees in the plan, unless they affirmatively opt out. Automatic enrollment typically diverts funds into a default investment option, which is usually structured to conform to DOL's regulation on “qualified default investment alternatives” (QDIAs), such as a target date fund. If the QDIA regulation is complied with, the responsible fiduciary has some limited protection from fiduciary liability with respect to the default investment. The previous regulation prohibited a fiduciary from selecting a fund from serving as a QDIA if the fund, or any of its component funds in a fund-of-funds structure, had investment objectives, goals, or principal investment strategies that include, consider, or indicate the use of one or more non-pecuniary factors in its investment objectives, even if the fund is objectively economically prudent from a risk-return perspective or even best in class. The Rule does not include such a prohibition.

As a practical matter, ERISA fiduciaries no longer need to exclude funds that consider ESG factors or that allocate to underlying funds that consider ESG factors from consideration as the plan's QDIA. This is of key importance as QDIAs, such as target date funds, have become the predominant investment in many 401(k) plans.

Exercise of Shareholder Rights and Proxy Voting

The Rule retains the principle that a fiduciary's duty to manage plan assets includes the management of shareholder rights, including the right to vote proxies. Under the Rule, when deciding whether to exercise shareholder rights and how to exercise such rights, plan fiduciaries must act solely in accordance with the economic interest of the plan, evaluating whether any particular factors (including ESG factors) are relevant to the decision in accordance with the principles-based approach discussed above.[1] The plan fiduciaries must consider any costs involved and exercise prudence and diligence in the selection and monitoring of any persons hired to assist with, or advise on, exercises of shareholder rights.

A fiduciary may adopt proxy voting policies setting out specific parameters on when the fiduciary will generally vote a proxy, if such policies are prudently designed to serve the plan's interests in providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. Plan fiduciaries are required to periodically review any proxy policies that they adopt. Regardless of the parameters set out in any particular proxy voting policy, a fiduciary may still chose to vote (or not vote) a proxy on a case-by-case basis if, in that case, the fiduciary determines its actions are prudent considering the significance of the matter and the costs involved.

Several commenters asserted that certain aspects of the Rule, including the removal of specific language that fiduciary duty “does not require the voting of every proxy or the exercise of every shareholder right,” the removal of specific monitoring provisions and specific recordkeeping requirements, and the removal of two safe harbors from the current regulation would result in increased reliance on proxy advisory firms. DOL acknowledged concerns raised by these commenters and emphasized that, to the extent that a fiduciary determines to utilize a provider of proxy advisory services, the fiduciary has a duty under the Rule's general monitoring provision to prudently select and monitor the provider of such services.

As a practical matter, the “monitoring” requirement does not generally mean that a fiduciary is required to monitor every vote or to second-guess voting decisions by a third party; however, if a fiduciary determines that the activities of an investment manager or proxy advisory firm are not being carried out in a manner consistent with appropriate proxy voting policies or guidelines, the fiduciary will be expected to take appropriate action in response (which could presumably, for example, include terminating the service provider).

FOOTNOTES

[1] Unlike the investment duties section of the Rule, the proxy voting section of the Rule does not contain a tie-breaker standard. Although DOL has indicated that the tie-breaker test is inapplicable in the proxy voting context, it also notes in the preamble to the Rule that the Rule's conditions are not violated just because stakeholders other than the plan would potentially benefit along with the investing plan, as a result of any particular voting outcome.

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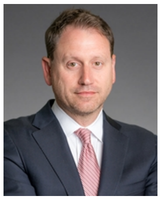

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